DOW THEORY LETTERS INC.

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THE MARKET: When the Dow Theory bear signal was given in 1950, following the long, tedious series of fluctuations and declines of 1946-49, I really did not see how a great bull market was going to express itself. Nothing in the news or the economy at that time indicated a bull market which, by 1954, would better the 1929 highs— then go on to almost triple the price of the 1929 peak.

In 1966, when I called a primary bear market, I did not foresee events which would occur to produce a primary bear market of really major proportions. It is not mine to reason why. It was enough, under Dow Theory, to recognize that the tide had turned.

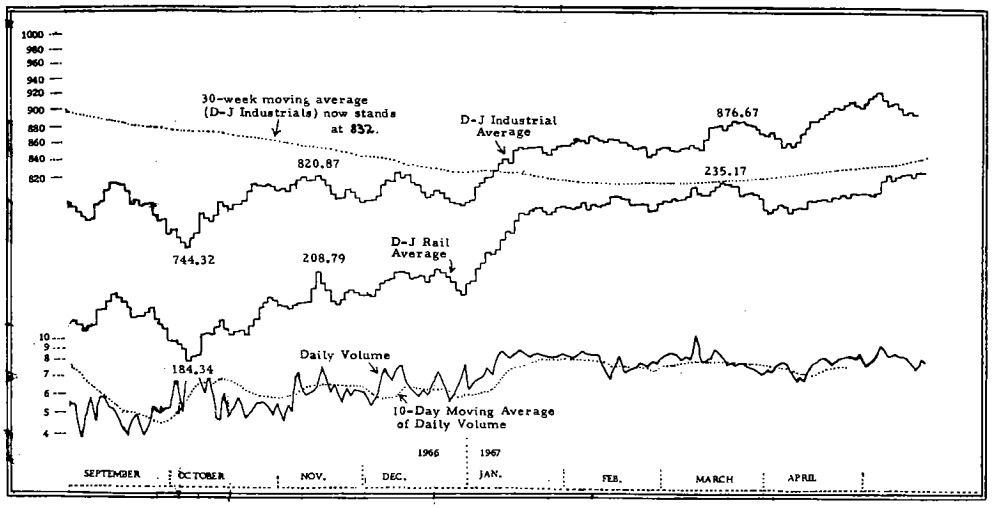
Nevertheless, despite the speculation on this bear market recovery, despite optimistic statements of Governmental leaders, I believe anybody with an ounce of imagination is receiving intimations of "potential" events which carry major bearish implications. Europe is in trouble economically. West Germany, the bastion of European economic strength, has been experiencing poor business for many months. Germany has lowered its bank rate four times (now to 3%) in an effort to combat their recession. Deficit financing has been resorted to, this despite the fact that such procedure is expressly forbidden by the German constitution.

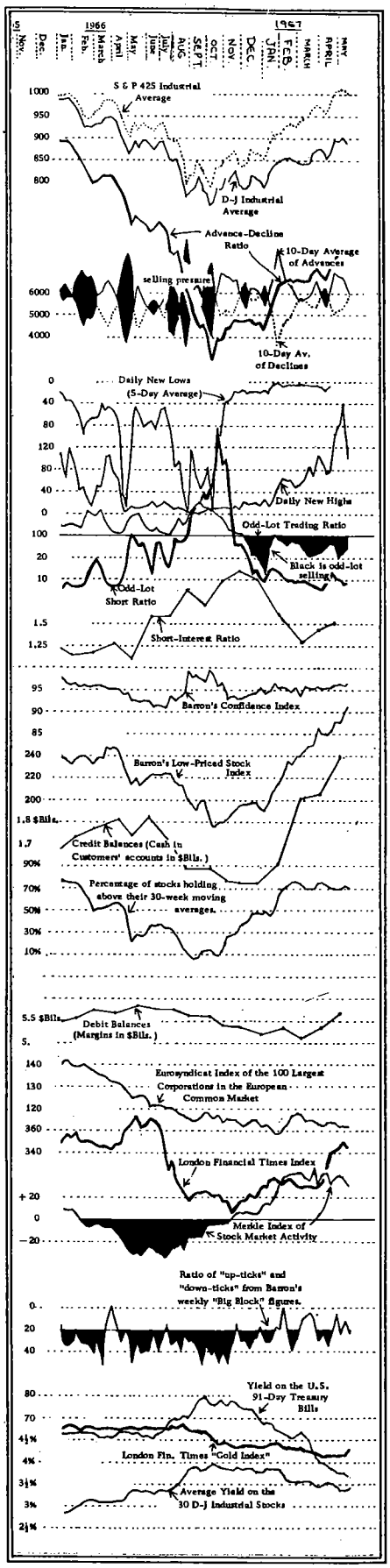
In the U.S., capital markets are buckling under the mightiest mass of corporate offerings in history. Corporations are rushing into the markets in an effort to grab long-term or short-term money, any kind of money. It is notable that this new cash is not wanted for capital expansion. In fact, an early report from the National Industrial Conference Board indicates that capital appropriations by major firms dropped sharply in the first quarter, down 20% to 25%. If true this would mean money earmarked for new plant and equipment expansion may have been the lowest for any quarter in a decade. Thus the new money is not needed for expansion, it is needed to produce liquidity for money-starved U.S. business.

ECONOMIC PICKUP slips further into the future, disappointing the Administration.

Johnson's seers find little cheer in the early reports for April, with retail sales down, joblessness edging higher. Initial rejoicing over March ended with a downward revision in the retail trade figures. The first-quarter drop in corporate profits alters forecasts of a gain for all 1967 over 1966; officials talk now of "a standoff" or outright decline.

The psychological impact of continued sluggishness worries Washington. Analysts hope the next survey of capital spending plans will be "neutral" rather than showing actual retrenchment. Some economists suspect more of the unemployed quit seeking jobs, leaving the unemployment rate deceptively low.




1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio
10-Day Average of Advances
selling pressure
10-Day Av. of Declines
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
Ratio of "up-ticks" and "down-ticks" from Barron's weekly "Big Block" figures.
Yield on the U.S. 91-Day Treasury Bills
London Fin. Times "Gold Index"
Average Yield on the 30 D-J Industrial Stocks

 The Government too is preparing to come into the capital markets for huge amounts of money. Last week the Treasury asked Congress to increase the debt ceiling to $365 billions, up another $29 billions from the last "ceiling." In anticipation, the bond markets are creaking lower, thereby forcing yields higher.

As the little clip from last week's Wall Street Journal (Page 1) suggests, all is not clear as to the remainder of 1967 or even the second quarter of 1967. Corporate tax receipts, in fact, could be down as much as $1 billion for the Government this year, thus widening the deficit which could push to over $20 billions for fiscal 1967-68.

The war in Vietnam is increasing in intensity, and the costs are sky-rocketing. The possibility of confrontation with Russia or China is increasing, and it is becoming clear that Russia is warning us not to count on a Communist "backdown" during any future confrontation.

Retail sales were revised downward for April, showing only a slight gain over April a year ago. And meanwhile, the eyes of the nation are focused on the machinations of the "New Economists," a group which has promised prosperity as long as they are allowed to manipulate the various factors which go to make up the U.S. banking system.

On the market front, it is clear that the stock market has been in the hands of the bullish "New Fund Managers." These men are dedicated to "performance", while disregarding the classical tenets of value. It is estimated that 35% of all N.Y.S.E. trading is now in the hands of the funds, the highest percentage in Exchange history. On May 3 the "Speculation Index," the ratio of S & P's High-Grade Stock Index to S & P's Low-Priced Index, rose to 1.83, its highest level in recent history (it was 1.67 on February 9, 1966). The ratio of volume on the speculative Amex continues to run around 40% of N.Y.S.E. volume, another indicator of intense speculative sentiment. The week ending May 12 provided another dramatic speculative show, when the Dow dropped 15.93 points against an actual rise of 8 points in Barron's Low-Price Stock Index. This is the type of action which was seen in the first quarter of 1966.

On May 12 the D-J Rail Average recorded a new recovery high of 237.68, but that same day saw the Industrial Average 19 points below its own recovery high (May 8) of 909.68. Thus another non-confirmation has materialized, just a few days after the Rails belatedly confirmed the previous Industrial high.

From another standpoint it is worth noting that the rally has now lasted about 7 months, versus the 8 month decline in 1966. Although no infallible rule, it is a good observation that most rallies in bear markets do not last as long as their preceding primary downward leg. Industrials at 909.68 (May 8) had retraced almost two-thirds of their 1966 decline. Since most bear market corrections ultimately recoup one-third to two-thirds of the preceding primary decline, this gauge too suggests that the rally could be nearing an end.

My conclusion is that none of the factors which so upset the market during 1966 have been resolved. In many cases, the problems have become more complicated, more ominous. This is a rally in the second phase of a primary bear market. It is probable that we are now witnessing one of the most deceptive "shows" ever produced by Wall Street. But in the end the bear will win. Meanwhile, proper investment procedure dictates that we be out of the bear market, regardless of rallies or declines. The wisdom of such procedure will be seen in time—probably before 1967 is out.

INFLATED VALUES (Chart page 3): I received a number of letters from subscribers asking for more on my statement in Letter 357 to the effect that...."At present common stocks in relation to top-grade bonds are the poorest value in history."

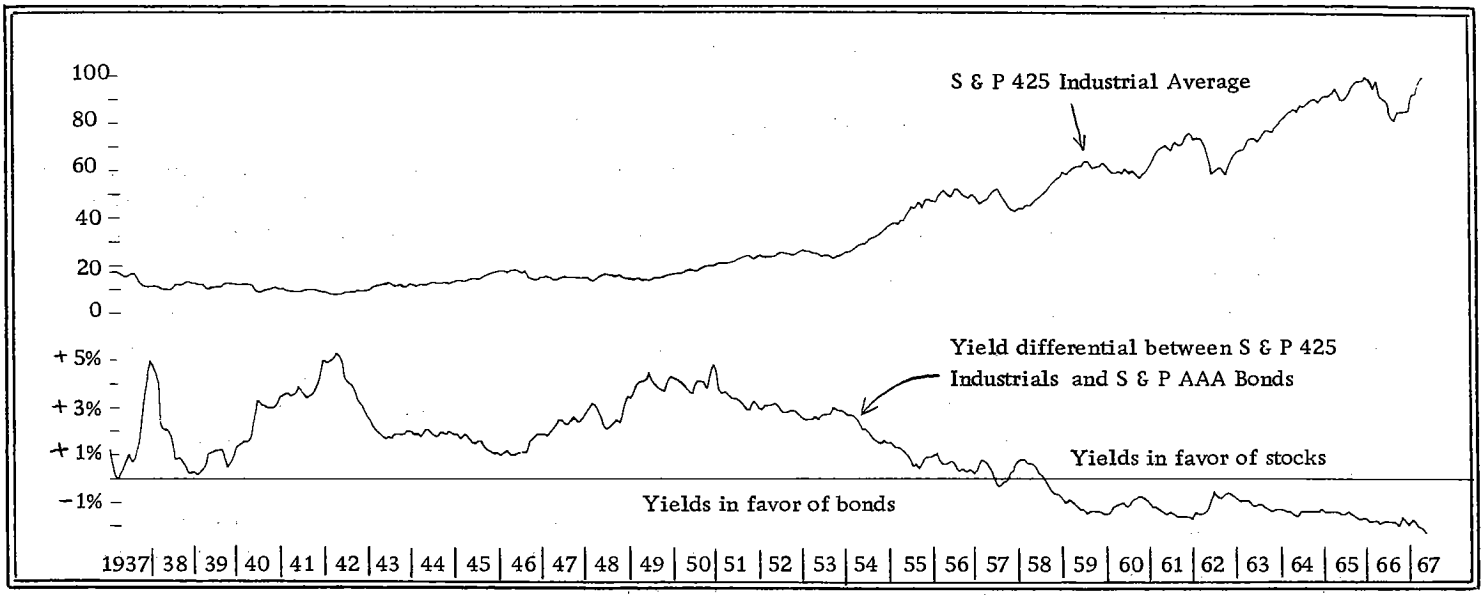
I do not like to deal in "secrets" or "mysteries". I have always insisted that my readers know as much as possible regarding both the market and my statements about the market. For this reason I have decided to publish a long-term chart which I have never seen in print before. Yet this chart depicts one of the most fundamental relationships on Wall Street.

I look upon this chart as a long-term "fortune builder." That sounds great doesn't it? But there is a catch, and a tremendous catch at that. The catch is that to use this chart correctly one has to exercise great patience, more patience than is possessed by perhaps 95% of the world's investors.

Great buying areas appear only 3, 4 or 5 times in a man's lifetime. When I say great buying areas, I mean that type of buying area which is calculated to make a man wealthy. This chart literally pin-points three such areas of great values in common stocks, early 1938, 1942 and 1949-1950. The chart utilizes a fundamental relationship, the spread between the yield on AAA bonds and the yield on the S & P 425 Industrial stocks.

During 1938, 1942 and 1949-50 the yield spread in favor of common stocks was almost 5% (actually above 5% in 1942). The implications were clear. During those periods everyone wanted bonds, the future of common stocks was doubted in the extreme, and the premium for top-rated bonds over stocks was a whopping 5%. This was the area of great values in common stocks. Wall Street was literally "giving equities away" in relation to top-grade bonds.

In 1949 the great bull market in common stocks started, and between late 1948 and 1950 the yield spread was saying that stocks were situated within the area of great values. Historically, this is the zone where informed investors accumulate. It makes sense to accumulate stocks when they provide a 4 to 5% premium over bonds. In such areas, either stocks are cheap or Wall Street is going out of existence. Furthermore, at the dividend rates of 1949-50 one could buy good stocks, collect the dividends, and wait forever for a bull market to begin.


100
80
60
40
20
0
+5%
+3%
+1%
-1%
S & P 425 Industrial Average
Yield differential between S & P 425 Industrials and S & P AAA Bonds
Yields in favor of stocks
Yields in favor of bonds
1937 38 39 40 41 42 43 44 45 46 47 48 49 50 51 52 53 54 55 56 57 58 59 60 61 62 63 64 65 66 67

The market embarked on its great rise of the 1950's. In late 1958 the yield spread turned negative, and investors were then actually paying a yield premium for stocks over bonds. Due to inflation and increasing optimism, the market was now sour on bonds but saw a continually brightening picture for equities.

In 1959 the negative yield spread went to minus 1.5. This proved too much for the market and the 1959-60 decline resulted. The yield spread corrected to under minus 1.0. During the 1961 market advance the negative yield spread went to a record minus 1.66. Again the market sold off and the yield spread corrected into 1962. A new rise began in October, 1962.

By February, 1966, the negative yield spread had climbed to a new record of minus 1.88, and this was followed by the bear market crack, a decline which carried to a low in October, 1966. Currently, due to a continuing sloppy bond market and a major retracement in stocks, the negative yield spread has risen to another new record. That record is minus 2.34 of May 10, 1967.

Based on the history of this chart, the market is now vulnerable again. It is in the area where previous records show important distribution has always occurred. From a long-term viewpoint, the market is particularly vulnerable since this new record yield spread has occurred within the context of a confirmed primary bear market.

How could such a huge yield spread have developed? It has occurred in the face of declining bond market matched by a fantastically speculative run-up in common stocks. It is my opinion that stocks are as vulnerable and over-priced now as they were strong and statistically cheap in 1949. In 1949 you couldn't argue anyone into purchasing even the best grade stocks. Now almost everybody and his brother is willing to speculate in the lowest grade "cats-and-dogs." But ultimately "values will out." The fundamental forces can be counted upon to exert their forces upon the market. I count everything since 1966 as part of the "distributive phase" of this bear market. The 1949-66 bull market was a 17 year bull market, and the bear market is going to undergo alot of distribution before the "writing is on the wall" for all to see. But the writing is on this chart as far as I am concerned. Investors should sit back in cash and let this chart tell its story. The worse the bond market, the higher the stock market, the more ominous the message as depicted on this chart.

LATE NOTES: After flooding the nation with money, the Federal Reserve's Mr. Martin had the affrontery to come out last week and warn that he sees "poisonous qualities reminiscent" of the booming 1920's in the stock trading practices of some institutional investors. Sure he's right; the "performance" acrobatics of some of today's funds is very reminiscent of the activities of the trusts during the 1920's. But so are the gyrations of the Fed. When it is all over, I am convinced that the Fed is going to be considered one of the chief culprits.....

Europe's slump is making the headlines as bank rates are lowered in an effort to get the various economies going again. April sales of cars in England were down 30% from last year, worst April in five years. In West Germany Volkswagen's domestic sales are down 35% from last year and 60,000 workers are on a short week. With the partial success of the Kennedy round of tariff cuts, the U.S. can expect some new vicious competition on the part of sales-hungry Europe. Such industries as steel, chemicals and textiles are going to be affected.

On May 15 DeGaulle delivered what one diplomat termed "a 20 minute burial" of British chances to join the Common Market. DeGaulle listed currency instability, "insularity," Commonwealth role, responsibilities in Asia, ties with the U.S. as barriers. As mentioned here before, DeGaulle does not want Europe to have to bail out a shaky reserve currency (pound), nor does he want Europe to accept an England which is tied to the U.S. with its inflated currency, its "paper gold" aspirations, and its staggering (should we say disastrous) commitments in Asia.

Below is the second installment of "Money and the Economy" by Michael Holzman. I urge subscribers to read this article carefully. Mr. Holzman, in my opinion, states the case with a clarity and a grasp of fundamentals which one finds only rarely among financial writers.

MONEY AND THE ECONOMY by Michael Holzman

A recent issue of Barron's noted "the letter of Bundesbank president Karl Blessing to Federal Reserve chairman William McChesney Martin stating the German central bank's intention not to swap dollars for gold—an understanding cancellable on short notice." Why do we need such promises, and what would be the implications of a change of heart by the Bundesbank? It is the purpose of this article and one which appeared here a few weeks ago to explore this subject.

In my last article (Letter 356) I discussed something of the theory of currency, backed and unbacked, and the consequences of removing the gold backing from the dollar. If you read that piece you will remember that it was argued that the purchasing power of the dollar was not wholly an economic phenomenon, but to an important degree a psychological one. The dollar is worth what people think it is worth. If they lose confidence in it, its value will drop. I postulated that if the gold backing of the dollar was tampered with, to any great extent, confidence would fall, first in Europe, then in the United States, and the value of the dollar would fall with it.

This is a relatively common occurrence in other parts of the world; witness the pound crisis of last summer and the history of the French franc during the 1950's. It is very rare with us, and when it begins to happen, the government can usually handle the situation by political means. What are those means, and what can be done to prevent loss of confidence and subsequent forced devaluation of a currency?

As with everything else, it depends on the circumstances. Let us begin by assuming that the threat to the currency is a balance of payments problem. (Here again we should note that there is no such thing as a balance of payments "crisis" in purely economic terms, at least not in the short run, with large countries. What happens is that people get nervous and place their money in other countries. This can cause a crisis, since they begin to dump the currency of the affected nation, thus starting the cycle described in my previous essay: declining demand forcing declines in value.) The government can then pursue a number of policies: restrict investments abroad, reduce imports with tariffs and regulations, stimulate domestic investment by foreigners, manipulate foreign debts, and, if the country is powerful enough, obtain co-operation from other less powerful nations (an example of this is the Bundesbank letter noted at the beginning of this article). In practice all of these are tried, and others too varied and technical to mention.

Another more unusual problem is that of massive external debts. These are usually occasioned by war or forced and rapid internal development. Examples of the first case are countries charged with indemities after a war, such as Germany and Austria after the First World War, or countries that have acquired debts in the course of a war, such as all western Europe after the Second World War. (It is perhaps not out of place to mention here that England's recurrent economic and monetary problems since the end of the Second World War are almost all traceable to the tremendous burden of debt and forced sale of assets that she endured as the price of defending the free world against Nazi Germany. Germany, having been fortunate enough to lose the war to the United States, rather than borrow from her , is very sound, economically). Examples of the second class are to be seen in any number of underdeveloped countries one might wish to list; say India, Egypt, and Brazil, for a fair distribution by continents. Here, too, a currency crisis occurs when confidence in the ability of the countries involved to pay their debts and be prosperous is shaken. There have not, to my knowledge, ever been any nations which have suffered monetary panics over the size of the internal debt, but I do not see why this could not happen.

The classical remedies for debt-ridden countries are two: either borrow more money, or renounce the debts. Neither of these is calculated to bolster investor confidence.

But how does this apply to the present? I believe that in my previous essay I established grounds for concern that the problem of the gold backing of the dollar and its convertibility into gold by foreigners has become sufficiently serious as to be in danger of setting off a monetary crisis and subsequent devaluation. Now, most of the categories enumerated above apply to the current situation in this country. We have a very serious balance of payments problem that the government is trying to conceal by juggling figures, a problem that remains in spite of that. We have a very large short-term foreign debt, mostly as a consequence of this balance of payments problem, and we are reaching the end of our international borrowing power. We have a colossal internal debt which is growing at as fast a rate as ever. And, as if that were not enough, it seems fairly clear, despite gestures like that of the Bundesbank, that Europe does not want to help solve our problems any longer.

I believe the danger signals are loud and clear. Events must change radically in the not too distant future, and by radically I mean drastically enough so that the dollar becomes as sound as the Swiss franc. This, in turn, means ending the Vietnamese war, achieving a fabulously favorable trade balance, and pursuing a general austerity program at home.

If these events do not come to pass, I believe we are in for a very serious monetary crisis, a crisis which will force the previously-listed measures on us against our will. We will then have to end the war in Vietnam because we will no longer be able to afford to wage it. We will have to institute severe trade restrictions and slash government spending. We will, in short, have to endure a very severe recession—if not something worse.